

SECURITIES AND EXCHANGE COMMISSION  
(Release No. 34-57352; File No. SR-CBOE-2008-07)

February 19, 2008

Self-Regulatory Organizations; Chicago Board Options Exchange, Incorporated; Notice of Filing and Order Granting Accelerated Approval of Proposed Rule Change, as Modified by Amendment No. 1, Requesting Permanent Approval of Two Pilot Programs That Increase Position and Exercise Limits

Pursuant to Section 19(b)(1) of the Securities Exchange Act of 1934 (“Act”)<sup>1</sup> and Rule 19b-4 thereunder,<sup>2</sup> notice is hereby given that on February 6, 2008, the Chicago Board Options Exchange, Incorporated (“CBOE” or “Exchange”) filed with the Securities and Exchange Commission (“Commission”) the proposed rule change as described in Items I and II below, which Items have been substantially prepared by the Exchange. The Exchange filed Amendment No. 1 to the proposed rule change on February 13, 2008. This order provides notice of the proposed rule change as modified by Amendment No. 1 and approves the proposed rule change as amended on an accelerated basis.

I. Self-Regulatory Organization’s Statement of the Terms of Substance of the Proposed Rule Change

The Exchange requests permanent approval of two pilot programs that increase position and exercise limits for equity options. The Exchange proposes to amend Rule 4.11, Position Limits, and Rule 4.12, Exercise Limits, to permanently establish the increased limits of the two pilot programs. The text of the proposed rule change is available at CBOE, the Commission’s Public Reference Room, and [www.cboe.org/legal](http://www.cboe.org/legal).

---

<sup>1</sup> 15 U.S.C. 78s(b)(1).

<sup>2</sup> 17 CFR 240.19b-4.

II. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

In its filing with the Commission, the Exchange included statements concerning the purpose of, and basis for, the proposed rule change and discussed any comments it received on the proposed rule change. The text of these statements may be examined at the places specified in Item III below. The Exchange has prepared summaries, set forth in Sections A, B, and C below, of the most significant aspects of such statements.

A. Self-Regulatory Organization's Statement of the Purpose of, and Statutory Basis for, the Proposed Rule Change

1. Purpose

The purpose of the proposed rule change is to request permanent approval of two pilot programs that increase position and exercise limits for equity options. The Exchange proposes to amend Rule 4.11, Position Limits, and Rule 4.12, Exercise Limits, to permanently establish the increased limits of the two pilot programs. Rule 4.11 subjects equity options to one of five different position limits depending on the trading volume and outstanding shares of the underlying security. Rule 4.12 establishes exercise limits for equity options at the same levels as the applicable position limits.<sup>3</sup>

The first pilot program, the "Rule 4.11 Pilot Program," commenced on February 23, 2005, and provides for an increase to the standard (or "non-pilot") position and exercise limits

---

<sup>3</sup> Rule 4.12 states, "no member shall exercise, for any account in which it has an interest or for the account of any customer, a long position in any option contract where such member or customer, acting alone or in concert with others, directly or indirectly, . . . has or will have exercised within any five consecutive business days aggregate long positions in any class of options dealt in on the Exchange in excess" of the established limits set by the Exchange.

for equity option contracts and for options on the PowerShares QQQ Trust (“QQQQ”).<sup>4</sup>

Specifically, the Rule 4.11 Pilot Program increases the applicable position and exercise limits for equity options and QQQQ options as follows:

<b>Standard equity option contract limit</b>	<b>Pilot Program equity option contract limit</b>
13,500 contracts	25,000 contracts
22,500 contracts	50,000 contracts
31,500 contracts	75,000 contracts
60,000 contracts	200,000 contracts
75,000 contracts	250,000 contracts
<b>Standard QQQQ option contract limit</b>	<b>Pilot Program QQQQ option contract limit</b>
300,000 contracts <sup>5</sup>	900,000 contracts

The second pilot program, the “iShares Russell 2000 Index Fund (‘IWM’) Option Pilot Program,” commenced on January 22, 2007, and increases the position and exercise limits for

<sup>4</sup> The Rule 4.11 Pilot Program was approved by the Commission on February 23, 2005. See Securities Exchange Act Release No. 51244 (February 23, 2005), 70 FR 10010 (March 1, 2005) (order approving SR-CBOE-2003-30, as amended) (“Pilot Program Order”). The Rule 4.11 Pilot Program has been extended 5 times for 6 month periods by the Commission, and expires on March 1, 2008. See Securities Exchange Act Release No. 52262 (August 15, 2005), 70 FR 48995 (August 22, 2005) (SR-CBOE-2005-61), Securities Exchange Act Release No. 53348 (February 22, 2006), 71 FR 10574 (March 1, 2006) (SR-CBOE-2006-11), Securities Exchange Act Release No. 54336 (August 18, 2006), 71 FR 50952 (August 28, 2006) (SR-CBOE-2006-69), Securities Exchange Act Release No. 55266 (February 9, 2007), 72 FR 7698 (February 16, 2007) (SR-CBOE-2007-12), and Securities Exchange Act Release No. 56266 (August 15, 2007), 72 FR 47094 (August 22, 2007) (SR-CBOE-2007-97).

In connection with the March 21, 2007 transfer of sponsorship of the Nasdaq-100 Trust, the name of the trust was changed to the “PowerShares QQQ Trust.” See QQQQ prospectus available at <http://www.powershares.com/pdf/P-QQQ-PRO-1.pdf>.

<sup>5</sup> The standard position and exercise limits for QQQQ options are 300,000 contracts. See Securities Exchange Act Release No. 45309 (January 18, 2002), 67 FR 3757 (January 25, 2002) (SR-CBOE-2001-44). The standard position and exercise limits for options on DIA and SPY are also 300,000 contracts. See Securities Exchange Act Releases Nos. 47346 (February 11, 2003), 68 FR 8316 (February 20, 2003) (SR-CBOE-2002-26), 51041 (January 14, 2005), 70 FR 3408 (January 24, 2005) (SR-CBOE-2005-06).

IWM options from 250,000 contracts to 500,000 contracts.<sup>6</sup>

a. Standard Position and Exercise Limits

The standard position limits were last increased nine years ago, on December 31, 1998.<sup>7</sup> Since that time, there has been a steady increase in the number of accounts that: (a) approach the position limit; (b) exceed the position limits; and (c) are granted an exemption to the applicable position limit. To illustrate CBOE's position on this matter, CBOE's Division of Market Regulation conducted a review of four incident categories involving position limits: (i) violations; (ii) accounts near 10% of pilots' position limits; (iii) account positions and pilots' limits vs. standard limits; and (iv) exemptions granted.

(i) Violations

During the period of January 1, 2007 through January 1, 2008, when both pilot programs were in effect, the Exchange opened a total of 19 reviews regarding equity option position and exercise limits at the pilot levels, which led to findings of 7 violations. To the best of the staff's knowledge, all of these violations were deemed inadvertent—due primarily to miscounting, technical problems, or a misinterpretation of position limit calculation methodologies. None of these violations were deemed to be a result of manipulative activities.

---

<sup>6</sup> The IWM Option Pilot Program doubles the position and exercise limits for IWM options under the Rule 4.11 Pilot Program. Absent both of these pilot programs, the standard position and exercise limit for IWM options is 75,000 option contracts.

The proposal that established the IWM Option Pilot Program was designated by the Commission to be effective and operative upon filing. See Securities Exchange Act Release No. 55176 (January 25, 2007), 72 FR 4741 (February 1, 2007) (SR-CBOE-2007-08). The IWM Option Pilot Program has been extended twice by the Commission and expires on March 1, 2008. See Securities Exchange Act Release No. 55926 (June 20, 2007), 72 FR 35275 (June 27, 2007) (SR-CBOE-2007-61); Securities Exchange Act Release No. 57141, 73 FR 3496 (January 18, 2008) (SR-CBOE-2007-147).

<sup>7</sup> See Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842 (January 12, 1999) (SR-CBOE-98-25).

(ii) Accounts Near 10% of Pilots' Position Limits

The Exchange utilizes a heightened surveillance technique to identify different types of accounts that are within 10% of the pilot position limit tiers. As of December 20, 2007, Exchange staff identified 36 accounts that were within 10% of the pilot position limit tiers. As illustrated below, the majority of the accounts were firm/market-maker accounts involving the 250,000 contract pilot position limit tier. The Exchange believes that members and large customers (e.g., mutual funds, hedge funds, and pension funds) are utilizing the higher limits in their portfolios and transactions with the confidence that they will not exceed the limits.

<u>Pilot Position Limit Tier</u>	<u>LOPR<sup>8</sup> 10%</u>	<u>Firm / Market- Maker 10%</u>	<u>LOPR 10% In Concert</u>	<u>LOPR / Aggregated Open Interest 10%<sup>9</sup></u>
25,000	0	0	0	1
50,000	0	0	0	0
75,000	1	0	0	0
250,000	6	10	0	4
300,000	1	7	1	1
500,000	0	1	0	0
900,000	<u>0</u>	<u>3</u>	<u>0</u>	<u>0</u>
<b>Total Accts</b>	<b>8</b>	<b>21</b>	<b>1</b>	<b>6</b>

(iii) Account Positions and Pilots' Limits vs. Standard Limits

Exchange staff examined approximately 160 member/firm accounts and approximately 754 customer accounts, as of December 2007, and compared the current contract quantities to:

(a) the Rule 4.11 and IWM Option Pilot Programs' position limits; and (b) the standard equity position limits. Without the increased position limits provided for by the Rule 4.11 and IWM

<sup>8</sup> Large Options Position Report ("LOPR").

<sup>9</sup> The LOPR/Aggregated Open Interest 10% report aggregates positions of affiliated accounts (i.e., those that clear in the customer range with those that clear in the firm proprietary and/or market-maker range), and reflects same side of the market positions that are within 10% of the applicable pilot position limit tiers.

Option Pilot Programs, virtually all of the customer accounts would be in violation of the standard position limits. The same, however, cannot be said of the member/firm accounts, as those accounts may utilize exemptions not available to customers. As a result, a significant amount of customers would be disadvantaged if the pilot programs' position limits levels are not made permanent.

(iv) Exemptions

Exchange staff examined position limit exemptions to the pilot position limit tiers as of December 20, 2007, and observed that among the various options exchanges, 53 exemptions to positions limits under the pilot position limit tiers were granted in equity option classes, the majority of which occurred in the 250,000 and 300,000 pilot tier levels.<sup>10</sup> In addition, seven exemptions to the position limit pilot tier of 500,000 contracts were granted in the IWM options class, which has a standard position limit of 75,000 contracts.

b. Growth in Options Market

Since the last position limit increase, there has been an exponential increase in the overall volume of exchange traded options. The below chart demonstrates the growth in options trading industry-wide between 1999 and 2007.

<b>Year</b>	<b>Annual Industry Options Trading Volume</b>
1999	508,000,000 contracts
2000	727,000,000 contracts
2001	782,000,000 contracts
2002	780,000,000 contracts
2003	908,000,000 contracts
2004	1,182,000,000 contracts
2005	1,504,000,000 contracts
2006	2,028,000,000 contracts
2007	2,863,000,000 contracts

<sup>10</sup> As to the 53 exemptions, the majority were granted prior to December 2007 and subsequently renewed.

Part of this volume is attributable to a corresponding increase in the number of overall market participants. This growth in market participants has in turn brought about additional depth and increased liquidity in exchange traded options.

c. Manipulation

Since the last position limit increase, and throughout the duration of the two pilot programs, the Exchange has not encountered any regulatory issues regarding the applicable position limits, and states there is a lack of evidence of market manipulation schemes, which justifies the proposed permanent approval of the Rule 4.11 and IWM Option Pilot Programs.

The Exchange believes that position and exercise limits, at the non-pilot levels, no longer serve their stated purpose. The Commission has previously stated,

Since the inception of standardized options trading, the options exchanges have had rules imposing limits on the aggregate number of options contracts that a member or customer could hold or exercise. These rules are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition, such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.<sup>11</sup>

As the anniversary of listed options trading approaches its 35th year, the Exchange believes that the existing surveillance procedures and reporting requirements at CBOE, at other options exchanges, and at the several clearing firms are capable of properly identifying unusual and/or illegal trading activity. In addition, routine oversight inspections of CBOE's regulatory programs by the Commission have not uncovered any material inconsistencies or shortcomings

---

<sup>11</sup> See Securities Exchange Act Release No. 39489 (December 24, 1997), 63 FR 276 (January 5, 1998) (SR-CBOE-97-11).

in the manner in which the Exchange’s market surveillance is conducted relating to position and exercise limits. These procedures include daily monitoring of market movements via automated surveillance techniques to identify unusual activities in both options and underlying stocks and Exchange Traded Funds (“ETFs”).

Furthermore, large stock holdings must be disclosed to the Commission by way of Schedules 13D and 13G. Options positions are part of any reportable positions, and thus cannot be legally hidden. The Exchange also requires that member organizations file reports with the Exchange for any customer who holds aggregate long or short positions on the same side of the market of 200 or more option contracts of any single class for the previous day.<sup>12</sup> In addition, the Exchange requires that firms and market-makers report their positions, and the Exchange has access, via The Options Clearing Corporation (“OCC”), to daily data with respect to these options positions. Finally, in granting firms’ requests for exemptions or disaggregation within firm positions, CBOE and the other options markets require enhanced reporting—either directly to the granting exchange or through LOPR, as applicable. In sum, these reporting requirements will continue to serve as an important part of the Exchange’s surveillance efforts.

Accordingly, the Exchange represents that its surveillance procedures (which have been significantly enhanced since the last position limit increase) and reporting procedures, in conjunction with the financial requirements and risk management review procedures already in place at the clearing firms and the OCC, will serve to adequately address any concerns the Commission may have with respect to account(s) engaging in any manipulative schemes or assuming too high a level of risk exposure.

---

<sup>12</sup> See Rule 4.13(a).



d. Financial Requirements

The Exchange believes that the current financial requirements imposed by the Exchange and by the Commission adequately address concerns that a member or its customer may try to maintain an inordinately large unhedged position in an equity option. Current margin and risk-based haircut methodologies serve to limit the size of positions maintained by one account by increasing margin and/or capital that a member must maintain for a large position held by itself or by its customer. The Exchange also notes that it has the authority under Rule 12.3(h) and Rule 12.10 to impose higher margin requirements upon a member or member organization when the Exchange determines that higher requirements are required. Also, the Commission's net capital rule imposes a capital charge on members to the extent any margin deficiency results from the higher margin requirement.<sup>13</sup>

e. Inability to Compete; Retreat to OTC Market

The Exchange has no reason to believe that the current trading volume in equity options will not continue. Rather, the Exchange expects continued options volume growth as opportunities for investors to participate in the options markets increase and evolve. The Exchange believes that the non-pilot position and exercise limits are restrictive, and returning to those limits will hamper fair and effective competition between the listed options markets and the over-the-counter ("OTC") markets. In fact, the Commission highlighted competition with the OTC markets as a reason for increasing the standard position and exercise limits in 1998.<sup>14</sup> Specifically, the Commission stated:

---

<sup>13</sup> See 17 CFR 240.15c3-1.

<sup>14</sup> See Securities Exchange Act Release No. 40875 (December 31, 1998), 64 FR 1842 (January 12, 1999) (SR-CBOE-98-25).

The increase in position and exercise limits for standardized equity options should allow the Exchanges to better compete with the growing OTC market in customized equity options, thereby encouraging fair competition among brokers and exchange markets.<sup>15</sup>

In addition, the Exchange believes that without permanently establishing the position and exercise limits set forth in the pilot programs, large customers, such as mutual funds, hedge funds and pension funds, will find the standard equity position limits an impediment to their business and investment objectives. As such, market participants may find the less-transparent OTC markets a more attractive alternative to achieve their investment and hedging objectives, leading to a retreat from the listed options markets, where trades are subject to reporting requirements and daily surveillance.

f. No Adverse Consequences From Past Increases

Equity option position limits have been gradually expanded from 1,000 contracts in 1973 to the current level of 75,000 contracts for the largest and most actively traded equity options. To date, there have been no adverse affects on the markets as a result of these past increases in the limits for equity option contracts.

2. Statutory Basis

The Exchange believes that the proposed rule change is consistent with the requirements provided under Section 6(b)(5) of the Act,<sup>16</sup> which state in part that the rules of an exchange must be designed to promote just and equitable principles of trade, to prevent fraudulent and manipulative acts, and, in general, to protect investors and the public interest.

---

<sup>15</sup> Id.

<sup>16</sup> 15 U.S.C. 78f(b)(5).

B. Self-Regulatory Organization's Statement on Burden on Competition

The Exchange does not believe that the proposed rule change will impose any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Act.

C. Self-Regulatory Organization's Statement on Comments on the Proposed Rule Change Received from Members, Participants or Others

The Exchange neither solicited nor received comments on the proposal.

III. Solicitation of Comments

Interested persons are invited to submit written data, views, and arguments concerning the foregoing, including whether the proposed rule change is consistent with the Act. Comments may be submitted by any of the following methods:

Electronic comments:

- Use the Commission's Internet comment form (<http://www.sec.gov/rules/sro.shtml>); or
- Send an e-mail to [rule-comments@sec.gov](mailto:rule-comments@sec.gov). Please include File Number SR-CBOE-2008-07 on the subject line.

Paper comments:

- Send paper comments in triplicate to Nancy M. Morris, Secretary, Securities and Exchange Commission, 100 F Street, NE, Washington, DC 20549-1090.

All submissions should refer to File Number SR-CBOE-2008-07. This file number should be included on the subject line if e-mail is used. To help the Commission process and review your comments more efficiently, please use only one method. The Commission will post all comments on the Commission's Internet Web site (<http://www.sec.gov/rules/sro.shtml>). Copies of the submission, all subsequent amendments, all written statements with respect to the proposed rule change that are filed with the Commission, and all written communications relating to the proposed rule change between the Commission and any person, other than those

that may be withheld from the public in accordance with the provisions of 5 U.S.C. 552, will be available for inspection and copying in the Commission's Public Reference Room, 100 F Street, NE, Washington, DC 20549, on official business days between the hours of 10:00 a.m. and 3:00 p.m. Copies of such filing also will be available for inspection and copying at the principal offices of the Exchange. All comments received will be posted without change; the Commission does not edit personal identifying information from submissions. You should submit only information that you wish to make available publicly. All submissions should refer to File Number SR-CBOE-2008-07 and should be submitted on or before [insert date 21 days from publication in the Federal Register].

IV. Commission's Findings and Order Granting Accelerated Approval of the Proposed Rule Change

After careful review, the Commission finds that the proposed rule change is consistent with the requirements of the Act and the rules and regulations thereunder applicable to a national securities exchange.<sup>17</sup> In particular, the Commission finds that the proposed rule change is consistent with Section 6(b)(5) of the Act<sup>18</sup> in that it is designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to remove impediments to and perfect the mechanism of a free and open market and a national market system, and, in general, to protect investors and the public interest.

The Commission believes that the proposal to permanently establish the increased position and exercise limits of the Rule 4.11 Pilot Program and the IWM Option Pilot Program is consistent with the Act. As the Commission previously has noted, rules regarding position and

---

<sup>17</sup> In approving this proposed rule change, the Commission notes that it has considered the proposed rule's impact on efficiency, competition, and capital formation. See 15 U.S.C. 78c(f).

<sup>18</sup> 15 U.S.C. 78f(b)(5).

exercise limits are intended to prevent the establishment of options positions that can be used or might create incentives to manipulate or disrupt the underlying market so as to benefit the options position. In particular, position and exercise limits are designed to minimize the potential for mini-manipulations and for corners or squeezes of the underlying market. In addition, such limits serve to reduce the possibility for disruption of the options market itself, especially in illiquid options classes.<sup>19</sup>

The Exchange has represented that, over the recent history of steadily increasing position and exercise limits, it has detected no adverse consequences and has received no complaints relating to their position and exercise limits or the Rule 4.11 and IWM Option Pilot Programs. According to the Exchange, it has not encountered any regulatory issues regarding the position limits subject to the two pilot programs or any instances of manipulation. Moreover, the Exchange pointed to the very significant increase in the overall volume of exchange-traded options since 1999. This growth in trading volume and number of market participants has brought additional depth and increased liquidity in exchange-traded options and thereby has lessened concerns about the potential for disruptions in the options markets that may occur through increased position and exercise limits.

The Commission expects the Exchange to continue to monitor for violations of the position and exercise limits with the purpose of discovering and sanctioning fraudulent or manipulative acts and practices, and to reassess the position and exercise limits, if and when appropriate, in light of its findings. Finally, the Commission notes that in approving the proposed rule change, it has relied upon the Exchange's representation that its surveillance

---

<sup>19</sup> See Securities Exchange Act Release No. 39489, supra note 11.

procedures and reporting requirements, discussed above, will continue to monitor for manipulative schemes or too high a level of risk exposure.

In light of the foregoing, the Commission believes that the current position and exercise limits under the two pilot programs represent an appropriate balance between the Exchange's desire to accommodate market participants by offering higher position and exercise limits, particularly in light of the marked increase in the volume of exchange-traded options in recent years, and the need to provide checks on potential market manipulation, imprudent assumption of risk (e.g., entering into large unhedged positions), and other potential trading abuses.

The Commission finds good cause for approving the proposed rule change before the 30th day after the date of publication of notice of filing in the Federal Register. The Commission notes that the Rule 4.11 Pilot Program and the IWM Option Pilot Program both expire on March 1, 2008. The Commission believes accelerated approval of the proposed rule change is appropriate in order to maintain uninterrupted position and exercise limit levels.

V. Conclusion

IT IS THEREFORE ORDERED, pursuant to Section 19(b)(2) of the Act,<sup>20</sup> that the proposed rule change (SR-CBOE-2008-07), as modified by Amendment No. 1, be, and it hereby is, approved on an accelerated basis.

For the Commission, by the Division of Trading and Markets, pursuant to delegated authority.<sup>21</sup>

Florence E. Harmon  
Deputy Secretary

---

<sup>20</sup> 15 U.S.C. 78s(b)(2).

<sup>21</sup> 17 CFR 200.30-3(a)(12).